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Private Equity Mechanics: How LBOs Are Structured and Financed

How PE funds structure and finance acquisitions, sources and uses analysis, debt financing components, equity contribution and returns analysis, and the financial governance the PE model requires

WHAT YOU WILL LEARN AND WHY IT MATTERS

A leveraged buyout is the most financially engineered transaction in the private capital universe. The PE firm's ability to generate exceptional returns on equity — often three to five times invested capital over a three-to-seven-year holding period — from businesses that grow at modest rates depends on a precise understanding of how the financial structure of the acquisition converts moderate business performance improvement into exceptional equity returns. The CFO who does not understand this financial engineering is working within a capital structure whose logic and incentives are opaque, and will consistently find themselves surprised by the financial priorities and governance expectations of the PE owner.

This part demystifies the LBO financial structure from first principles: how the acquisition is financed, how the debt and equity components interact over the holding period, and how the specific financial decisions of the PE fund — the leverage ratio, the debt structure, the equity contribution, the acquisition multiple — create the return arithmetic that the fund is working to achieve. This understanding is not merely academic — it directly informs how the CFO should prioritize financial management activities during the PE ownership period and how the CFO should frame financial decisions for the PE sponsor's governance review.

THE LBO FINANCIAL STRUCTURE

An LBO acquisition is financed by a combination of debt (borrowed against the cash flows and assets of the acquired business) and equity (the PE fund's investment from its limited partners' capital). The ratio of debt to equity — typically two to three dollars of debt for every one dollar of equity — is the primary mechanism by which the PE fund amplifies its return on invested equity.

THE SOURCES AND USES ANALYSIS: The sources and uses analysis is the fundamental financial accounting of the LBO transaction. Uses of funds: the total purchase price (the enterprise value of the acquisition, typically expressed as a multiple of EBITDA — "we are paying seven times EBITDA"), plus transaction fees (investment banking fees, legal fees, and financing fees that are capitalized and amortized over the life of the debt). Sources of funds: the senior secured debt, the second lien or mezzanine debt, and the equity contribution from the PE fund. The sources must equal the uses — and the debt that can be raised is limited by the acquired company's EBITDA and the debt markets' appetite for the company's credit profile.

A typical LBO sources and uses for a company with fifty million dollars of EBITDA acquired at a seven-times multiple: Purchase price: \$350 million. Transaction fees: \$15 million. Total uses: \$365 million. Senior secured debt at four times EBITDA: \$200 million. Mezzanine debt at one times EBITDA: \$50 million. PE equity: \$115 million. Total sources: \$365 million.

The PE fund's equity of \$115 million represents 31.5 percent of the total acquisition cost — the remainder is financed with debt that the acquired business must service from its operating cash flows.

THE LEVERAGE RATIO: The leverage ratio — total debt divided by EBITDA — is the primary measure of the financial risk embedded in the LBO capital structure. At the time of acquisition, the leverage ratio in the example above is five times (two hundred and fifty million dollars of debt divided by fifty million dollars of EBITDA). Over the holding period, as the company generates cash and repays debt, the leverage ratio declines — a process called deleveraging that is one of the three primary sources of PE equity return alongside EBITDA growth and multiple expansion.

LBO DEBT COMPONENTS

The debt in a PE acquisition is not a single monolithic obligation — it is a multi-layered capital structure with different components that differ in their security, their interest rate, their maturity, and their covenants. The CFO must understand each component and its specific financial management requirements.

SENIOR SECURED CREDIT FACILITY: The senior secured credit facility — the largest debt component in most LBOs — is a package of bank loans that typically includes a term loan (a fully drawn, amortizing loan that the company repays on a scheduled basis over five to seven years) and a revolving credit facility (a line of credit that the company can draw and repay as needed to manage working capital fluctuations). The term loan typically amortizes one percent of its face value per year with a balloon payment at maturity (the remaining principal due at the end of the term), and it carries a floating interest rate (typically SOFR plus a spread of two to four percentage points). The senior secured facility carries the tightest financial covenants — leverage ratio, interest coverage, and minimum liquidity — that the CFO must monitor monthly.

SECOND LIEN AND MEZZANINE DEBT: Second lien debt and mezzanine debt occupy the middle of the debt capital structure — they rank below the senior secured debt in priority but above the equity. Second lien debt carries a higher interest rate than the senior debt (reflecting the subordinate position) and typically has less restrictive covenants. Mezzanine debt — which can take the form of subordinated notes or preferred equity — is the most expensive debt component and often carries PIK (payment-in-kind) features that allow the interest to be added to the principal rather than paid in cash, reducing the near-term cash drain on the business at the cost of increasing the total debt outstanding.

HIGH YIELD NOTES: For larger LBOs, the mezzanine component is often replaced by high yield notes — publicly traded bonds that are issued in the capital markets rather than provided by a single lender. High yield notes are typically five to seven year fixed-rate instruments that provide certainty of cost but less flexibility for amendment and waiver than bank debt.

THE LBO RETURN MATH

The PE fund's return on equity investment — the equity multiple and the IRR — is determined by three factors: EBITDA growth (the improvement in the acquired company's operating earnings over the holding period), leverage (the reduction in debt outstanding, which increases the equity value without any increase in enterprise value), and multiple expansion (an increase in the valuation multiple at exit relative to the entry multiple). Understanding how each factor contributes to the return illuminates the PE sponsor's financial priorities during the holding period.

THE RETURN CALCULATION: In the example above, the PE fund invested \$115 million of equity at the entry. If the company grows EBITDA from \$50 million to \$75 million over five years (a \$25 million improvement), reduces its total debt from \$250 million to \$150 million through cash generation (a \$100 million debt reduction), and exits at the same seven-times EBITDA multiple: the exit enterprise value is \$525 million (seven times \$75 million), less the remaining debt of \$150 million, equals exit equity value of \$375 million. The PE fund's return on the \$115 million equity investment is \$375 million — a 3.3 times equity multiple, equivalent to approximately twenty-seven percent IRR over five years.

This return decomposition reveals the relative importance of each value creation lever: the EBITDA growth contributed approximately \$175 million to exit equity value (the enterprise value increase from \$350 million to \$525 million), the debt repayment contributed approximately \$100 million (the reduction in debt from \$250 million to \$150 million), and the multiple was flat. Multiple expansion — which has historically contributed to PE returns when the company exits at a higher multiple than the entry multiple — is outside the PE fund's control and should not be relied upon as a primary value creation lever.

THE CASH FLOW PRIORITY: The leverage ratio and the debt repayment schedule create a specific cash flow priority during the PE holding period: debt service — interest and scheduled principal — ranks ahead of every other use of the company's cash. The CFO must manage the company's cash generation with an acute awareness of the debt service obligation and must ensure that the company's financial plan generates sufficient free cash flow to service the debt, fund the minimum operating investment required to sustain the business, and provide the PE sponsor with the capital available for value creation initiatives.

PE FINANCIAL GOVERNANCE: WHAT THE PE SPONSOR REQUIRES

PE ownership creates the most intensive financial governance environment that a private-company CFO will encounter. The PE sponsor — whose equity return depends directly on the company's financial performance — exercises governance through monthly financial reporting, board oversight, and a set of financial controls and approval requirements that are substantially more demanding than the governance of a venture-backed or growth-equity-backed company.

THE MONTHLY REPORTING PACKAGE: PE sponsors typically require a monthly reporting package that includes: the income statement, balance sheet, and cash flow statement versus plan and versus prior year; a detailed EBITDA bridge from plan to actual; the covenant compliance certificate for every debt facility; the thirteen-week cash flow model update; and the key operational KPIs. The close process must

produce this package within seven to ten business days of month-end — a timeline that requires a well-staffed, well-organized accounting function and a close process discipline that leaves no room for the informal monthly close procedures that many early-stage companies use.

THE ANNUAL BUDGET APPROVAL: The PE sponsor's approval of the annual budget is a formal governance event that requires the company's financial plan to be reviewed, challenged, and approved by the board — including the PE sponsor's management company representatives — before the fiscal year begins. The budget process typically begins in October and requires board approval by early December, giving the management team two to three months to develop a financial plan that is sufficiently ambitious to be consistent with the PE sponsor's value creation thesis and sufficiently achievable to be credible to a sophisticated financial investor.

THE VALUE CREATION INITIATIVE GOVERNANCE: Most PE sponsors maintain a formal value creation initiative list — a set of specific operational and financial improvement projects that are expected to contribute to EBITDA improvement and enterprise value creation over the holding period. The CFO is typically responsible for tracking the financial progress of these initiatives and reporting on the cumulative EBITDA impact in the monthly reporting package. This initiative tracking creates a clear line of accountability between the operational decisions made during the holding period and the financial outcomes that determine the PE fund's return.

ACTIONS TO TAKE BEFORE PART EIGHTEEN

Build the LBO return model for the current PE ownership situation: the entry enterprise value and EBITDA multiple, the debt structure and current balance outstanding, the current EBITDA and trajectory, and the range of exit enterprise values at different EBITDA growth and exit multiple scenarios. For each scenario, calculate the expected equity multiple and IRR for the PE fund. This model reveals which combination of EBITDA growth and debt repayment is required for the PE fund to achieve its target return, which informs the prioritization of value creation initiatives and the financial management priorities during the holding period.

Review the current covenant compliance position for every debt facility: the current financial ratios versus covenant thresholds, the forward covenant projection under the base case financial plan, and the covenant headroom under a stress scenario in which EBITDA is ten to fifteen percent below plan. Present this analysis to the PE sponsor and the board as a standing element of the monthly reporting package.

CLOSING PERSPECTIVE

The LBO financial structure is the mathematical foundation of the PE ownership relationship. The CFO who understands this structure — who can decompose the PE fund's return into its three components, who understands how the debt service obligation constrains the company's financial flexibility, and who manages the monthly reporting and covenant compliance with the rigor the structure demands — is operating with the financial intelligence that makes the PE ownership period productive rather than merely intensive. The CFO who does not understand the structure will find themselves constantly reacting to financial pressures whose logic and urgency are not fully understood.

COMING NEXT IN THE SERIES

Part 18 — Due Diligence from the Target's Side: What PE Buyers Actually Examine

Part Eighteen covers financial due diligence from the perspective of the company being acquired by a PE fund — what PE buyers examine most intensively, how to prepare the data room and management presentations, the quality of earnings process from the seller's side, and the CFO's role in managing the diligence process efficiently while running the business.